

United States
COURT OF APPEALS
for the Ninth Circuit

ARTHUR S. FLEMMING, Secretary of Health, Education and Welfare,

Appellant,

v.

HELMER F. LINDGREN,

Appellee.

On Appeal from the Judgment of the United States District Court for the District of Oregon.

BRIEF FOR THE APPELLEE

EUGENE F. FELTZ,
JACOB, JONES & BROWN,

623 Public Service Building,
Portland, Oregon,

Of Attorneys for Helmer F. Lindgren, Appellee.

INDEX

	Page
Jurisdiction	1
Statement of the Case.....	2
Statutes Involved.....	4
Summary of Argument.....	5
Argument:	
I. The District Court did not err in holding that the appellant cannot arbitrarily and capri- ciously disallow wages paid by an employer to a bona fide employee	6
II. The District Court has the power and duty to determine whether the appellant has cor- rectly applied the law to the facts	13
Conclusion	15

TABLE OF CASES

	Page
Aubrey v. Folsom, 151 F. Supp. 836 (1957).....	14
Ayers v. Hobby, 123 F. Supp. 115 (1954).....	14
Folsom v. Pearsall, 245 F. 2d 562 (CA 9, 1957).....	15
Fuller v. Folsom, 155 F. Supp. 348 (1957).....	14
Gancher v. Hobby, 145 F. Supp. 461 (1955).....	7, 8, 9
MacPherson v. Ewing, 107 F. Supp. 666 (1952).....	10, 14
Miller v. Burger, 161 F. 2d 992 (CA 9, 1957).....	14
Rhoads v. Folsom, 252 F. 2d 377 (CA 7, 1958).....	7
United States and Social Security Board v. LaLone, 152 F. 2d 43 (CA 9, 1945).....	13

STATUTES

Social Security Act, 49 Stat. 622, as amended:

Sec. 202 (42 U.S.C. 402).....	4
Sec. 205(g) (42 U.S.C. 405(g)).....	1, 4
Sec. 209 (42 U.S.C. 409).....	4, 5, 6
28 U.S.C. 1291.....	1

**United States
COURT OF APPEALS
for the Ninth Circuit**

ARTHUR S. FLEMMING, Secretary of Health, Education and Welfare,

Appellant,

v.

HELMER F. LINDGREN,

Appellee.

On Appeal from the Judgment of the United States District Court for the District of Oregon.

BRIEF FOR THE APPELLEE

JURISDICTION

On June 7, 1957, appellee's claim for old-age insurance benefits was finally denied by the Secretary of Health, Education and Welfare. Appellee instituted this action in the United States District Court for the District of Oregon on July 23, 1957 to obtain review of this denial (R. 17). The jurisdiction of the district court was invoked under Section 205(g) of the Social Security Act, as amended, 42 U.S.C. 405(g). Judgment was entered against the United States on June 9, 1958 and a notice of appeal was filed July 2, 1958 (R. 18). The jurisdiction of this Court rests upon 28 U.S.C. 1291.

STATEMENT OF THE CASE

The facts in the instant case are fairly clear. Prior to 1953, the appellee operated a farm for many years, raising fryers. Upon inquiry concerning social security benefits, the appellee was told that his business was excluded from coverage under the Social Security Act, but he could be covered if he was an employee of a corporation. Upon this advice, appellee consulted with his attorney and his business was incorporated and he became an employee of the corporation, Lindgren and Company. The appellee freely stated that the purpose for incorporating was to obtain coverage under the Social Security Act (R. 34).

After formation, the corporation operated the business of raising fryers and hired the appellee as an employee who performed practically all of the work of the corporation (R. 35, 36). The corporation paid appellee for his services the sum of \$3,600.00 in 1953 and \$2,925.00 in 1954, which said sums appellee received and reported on his personal federal income tax returns for said years as income and paid income taxes thereon (R. 48, 54). Due to the unstable market conditions in the poultry business, thereby causing the corporation to lose \$1,644.17 in 1953 and \$35.99 in 1954, the appellee's salary was reduced in the latter part of 1954 (R. 46).

From the time of its incorporation, the funds of the corporation were kept entirely separate from the appellee's and the bank account of the corporation was used

exclusively for company business (R. 28). Like many other employees paid on a monthly basis, appellee sometimes received an advance on his salary which was subsequently repaid when he received his pay check at the end of the month (R. 27, 28). There is no question that appellee was a bona fide employee of the corporation during the years 1953 and 1954. As stated by the referee in his decision (R. 22):

".... It is unquestioned here that as an officer of Lindgren and Company, commencing in February, 1953, the claimant was in an employment relationship, within the meaning of section 210 of the Social Security Act, and, specifically, section 210 (k)(1)."

Thus, the only question involved is whether the sums of \$3,600.00 and \$2,925.00 paid to appellee as wages during the years 1953 and 1954 constituted "wages" subject to the Social Security Act. The Department of Health, Education and Welfare, in denying appellee's claim for old-age insurance benefits, stated that "the alleged wages represented repayment of funds which you had advanced to the corp.; and after repayment of such advances the corp. did not show sufficient profit to support a finding of wages paid except for \$744.84 for the first quarter of 1954." Said determination was upheld by the referee who referred again to the lack of profits after allowance for repayment of advances as the basis for his decision (R. 29). The appellant then adopted the decision of the referee as his final decision.

In the first two years of the corporation, loans were made by appellee to the corporation in the sum

of \$1,900.00 in 1953 and \$1,000.00 in 1954 (Exhs. 25, 26, 27, 28, Tr. 136-143). Of these loans, \$600.00 was actually repaid as of December 31, 1955 (R. 27, 76). There is still owing on said notes the sum of \$2,300.00. No other loans were made after 1954 (R. 48). The appellee looks to the Oregon Egg Producer Cooperative Certificates owned by the corporation for the repayment of his loans (R. 49, 50). Said certificates have a total market value of \$2,590.00 (R. 51).

Apparently, it is the contention of the appellant that before remuneration actually paid an employee can constitute "wages" under Section 209 of the Social Security Act, the employer must show sufficient profit to pay such wages, and in determining said profit, all loans made by the said employee to the employer must first be repaid, and all rent accrued, paid (R. 29).

STATUTES INVOLVED

The pertinent sections of the Social Security Act, 49 Stat. 622, as amended, 42 U.S.C. 401 et seq., provide:

Section 202. [42 U.S.C. 402] *Old-age and survivors benefit payments—insurance benefits.*

Every individual who—

(a) is a fully insured individual (as defined in section 414(a) of this title) * * * shall be entitled to an old-age insurance benefit for each month * * * such individual's old-age insurance benefit for any month shall be equal to his primary insurance amount (as defined in section 415(a) of this title) for such month.

Section 205(g) [42 U.S.C. 405(g)]. *Review.*

Any individual, after any final decision of the Administrator made after a hearing to which he was a party, irrespective of the amount in controversy, may obtain a review of such decision by a civil action * * *. As part of its answer the Administrator shall file a certified copy of the transcript of the record, including the evidence upon which the findings and decision complained of are based. The court shall have power to enter, upon the pleadings and transcript of record, a judgment affirming, modifying, or reversing the decision of the Administrator, with or without remanding the cause for a rehearing. The findings of the Administrator as to any fact, if supported by substantial evidence, shall be conclusive * * *.

Section 209. [42 U.S.C. 409]. *Definition of wages.*

For the purposes of this subchapter, the term "wages" means * * * a remuneration paid after 1950 for employment * * * except that in the case of remuneration paid after 1950, such term shall not include—

- (a) That part of the remuneration which after remuneration * * * equal to \$3,600 with respect to employment has been paid to an individual during any calendar year, is paid to such individual during such calendar year.

SUMMARY OF ARGUMENT

Although the appellant is entitled to scrutinize the relationship between employer-employee, and further, to ascertain whether remuneration paid the employee is actually "wages" for services rendered, still he cannot

arbitrarily and capriciously determine that remuneration paid an employee does not qualify as "wages" under the Social Security Act merely because the employer may have lost money in the year said remuneration was paid. No such statutory power has been conferred upon him. Therefore, the district court did not err in holding that the appellant erroneously applied the law to the facts in the instant case by arbitrarily and capriciously denying the appellee's claim for social security benefits.

I.

The district court did not err in holding that the appellant cannot arbitrarily and capriciously disallow wages paid by an employer to a bona fide employee.

Contrary to the contentions of the appellant in his brief, the district court did not hold, in reversing appellant's denial of appellee's claim for social security benefits, that the appellant cannot inquire into whether purported wages paid an employee were actually remuneration for services performed. What the district court did hold was that the appellant cannot arbitrarily and capriciously disallow "wages" paid to a bona-fide employee for services rendered merely because the employer is a closely-held corporation which did not make "sufficient profit" during the years in which the wages were paid (R. 11).

The Social Security Act defines the term wages as "remuneration paid . . . for employment . . ." (42 U.S.C. 409). In the instant case before the court, it is not disputed that there was a bona fide employment rela-

tionship between the appellee and his employer, Lindgren & Company, during the years in question, 1953 and 1954. The referee so found in his decision (R. 22). Although the appellee incorporated his poultry business for the purpose of entering to such employment relationship so as to be covered by the Social Security Act, the Referee freely admitted "There is nothing improper in that" (R. 62). Furthermore, the district court found the record absolutely devoid of any fraud or deceit on the part of the appellant (R. 11). In the case of *Gancher v. Hobby*, 145 F. Supp. 461 (1955), the District Court for the District of Connecticut quoted the following language of the Referee:

" . . . There is nothing improper or questionable about a person entering bona fide employment for the express purpose of acquiring a wage record which will enable him to qualify for an old-age insurance benefit"

The Court of Appeals for the Seventh Circuit, in *Rhoads v. Folsom*, 252 F. 2d 377 (1958), reached a similar conclusion in stating:

"It may be true that the arrangement by which Mr. and Mrs. Rhoads were each to be paid was for the purpose of bringing them within the coverage of the Social Security Act. Even so, we see no legal impropriety in their so doing if in fact they both rendered services for which they were paid in accordance with an agreement"

The *Gancher* case was cited by the referee in his decision "as of precedent value in the disposition of the instant claim" of the appellee (R. 31), and the appellant relies heavily upon it to support his contentions. However, a mere reading of that case shows the following distinguishing points not found in the instant case.

First, in the *Gancher* case, the referee and the court rightly concluded that the claimant failed to establish any valid employment relationship. The claimant was a physician who became an officer of the corporation which he alleged to be his employer. However, he actually performed no services for the corporation other than to collect rent from himself and relatives who were tenants of the building owned by the corporation. As stated by the referee in his findings, and quoted by the court:

".... The picture of the claimant, as an individual, making rental payments to himself as an officer of the corporation and then, in turn, paying himself for his 'services' to the corporation approaches the farcical."

Such is clearly distinguishable from the facts of the instant case where the appellee, besides being an officer of his corporate employer, was the only employee of said corporation and as such, worked long and laborious hours in raising fryers and other poultry for sale. The appellee, unlike the claimant-physician in the *Gancher* case, has no other profession or source of income for his livelihood. Surely it cannot be said that \$300.00 a month is an excessive wage for the full-time services rendered by the appellee herein.

Secondly, it was pointed out in the *Gancher* case that the only income of the alleged corporate employer was rent received from the claimant-physician and his relatives, as stated above. But in the instant case, the income of appellee's corporate employer was practically all from the sale of fryers and allied farm products

(R. 25), the very business of the employer. Such income could not have been received by the corporate employer were it not for the services performed by the appellee employee.

Third, the evidence in the *Gancher* case showed the alleged corporate employer had a life of less than two years, and the claimant-physician received wages only during the minimum period of six quarters necessary for social security coverage. In fact, the referee in his decision, stated that evidence indicated that the claimant actually received the purported salary payments in only three calendar quarters during the existence of the corporation. In contrast, the corporation in this case was over four years old at the time of the hearing before the referee on April 3, 1957, and was still operating the fryer business. Also, the appellee herein actually received from his employer wages for his services during this whole period. These wages were in fact paid to appellee in cash (R. 48) and were not "mere bookkeeping entries" as suggested by appellant. Thus, the *Gancher* case is entirely distinguishable from the instant case.

Since the appellee herein was a bona fide employee under the Social Security Act and actually received remuneration for his services, the only grounds given by the referee for denying the appellee's claim for old-age benefits was that "the corporation did not show sufficient profit to support a finding by the referee that the alleged remuneration constituted 'wages'." (R. 29). The inference logically follows that if the corporate employer, Lindgren and Company, had shown sufficient profits in the years involved herein, the claim of the appellee

would not have been denied. It is unquestioned that this poultry business had been operated for many years for the purpose of making a profit, but it was only due to the economic slump in this field of farming that caused the losses incurred by Lindgren and Company in 1953 and 1954. Actually the loss in 1954 was only \$35.99 after the payment of wages to appellee in the amount of \$2,925.00 (R. 77).

In order to support his conclusion, the referee adjusted the profit and loss statements of the employer to allow for repayment of loans and payment of reasonable rent, and further offset the resulting loss of one year against the other. In other words, it is the contention of the referee and appellant that the employer in this case must first repay his loans and also pay a reasonable rent for the farm owned by the appellee before it could pay remuneration to the appellee employee for his services.

Neither the referee in his decision nor the appellant in his brief has cited any law, regulation, or court decision to the effect that an employer must show a "sufficient profit" after repayment of all loans and expenses before it can pay an employee wages for his services. Appellee, in his research of the law and the cases decided thereunder, also could find no such rule.

On the other hand, in the somewhat analogous case of *MacPherson v. Ewing*, 107 F. Supp. 666 (1952), where the Social Security Administrator denied the employee's widow's claim for benefits due to the motives of the employer or the effectiveness or adequacy of the

employee's services or labor, the court, in holding for the widow, said:

"Whatever may have been the motives of the employer, whether prompted by generosity or selfishness, they are immaterial in determining the nature of the payments. The record, without dispute, shows that the relation of the employer and employee existed. To permit the administrator to rest his decision upon the *motives* of the employer or upon the *effectiveness* or *adequacy* of the employee's services or labor, absent any element of fraud or deceit, would be to entrust to him a power far beyond that statutorily conferred upon him.

"Upon the record, therefore, the decision of the administrator must be considered, in law, to be arbitrary and capricious."

To paraphrase the language of the court above, to permit the appellant in the instant case to disallow the claim of the appellee upon the financial condition of his employer, after making certain adjustments to the profits and losses of the employer for the years involved, would be to entrust him with powers far beyond that statutorily conferred upon him. Such action of the appellant is certainly arbitrary and capricious. If allowed to stand, every employee receiving remuneration for services rendered an employer which shows a loss instead of a profit would not be considered to have received "wages" under the Social Security Act, at least insofar as closely-held corporations are concerned.

Further, the referee was in obvious error in holding that the corporate employer did not show sufficient profit to support the payment of wages to the appellee. The very Federal Income Tax returns of the employer

show losses of only \$1,644.17 and \$45.99 in 1953 and 1954 respectively, which losses were determined after the deduction of the wages paid to the appellee in those years in the amounts of \$3,600.00 and \$2,925.00 (R. 26). The referee erroneously assumed that in computing a profit or loss of a business, you must deduct the amount borrowed by the business. Such loans are liabilities of a business, but the repayment thereof does not constitute an expense of the business in the determination of profits or losses.

As stated by the appellee at the hearing, the loans by the appellee to the corporate employer in the total sum of \$2,900.00 were not repaid during the years 1953 and 1954, but \$600.00 was repaid December 31, 1953 (R. 27, 76). The appellee holds notes for the balance of \$2,300.00 and looks to the cooperative patronage certificates owned by the corporate employer for the repayment of these notes (R. 49). Said certificates have a value of \$2,500.00 (R. 50) and can be cashed in at any time. They draw 5 per cent interest (R. 52). Thus, the finding of the referee that the remuneration paid to the appellee during the years involved represented repayment of funds loaned to the corporate employer is arbitrary and capricious and not based upon fact. This is not the situation of an employer receiving no other funds with which to pay wages other than amounts borrowed from its employees, for in the instant case the employer was operating a going business from which it received \$9,731.67 and \$9,480.09 in gross sales during the years 1953 and 1954 respectively, whereas the loans amounts to only \$1,900.00 and

\$1,000.00 in those respective years. It is not uncommon for an employee-stockholder of a small corporation to loan money to his corporation when the needs of the business demand it.

II.

The district court has the power and duty to determine whether the appellant has correctly applied the law to the facts.

It is not disputed that Section 205(g) of the Social Security Act provides that the findings of the referee (as adopted by the Secretary) as to any fact shall be conclusive, if supported by substantial evidence. However, it is not the findings of fact of the referee which the appellee disputes in this case, but rather, the inference and conclusions of law drawn by the referee from those facts. It is true that the same finality as to findings of fact extends to the inferences and conclusions drawn from the facts, but only if there is a substantial basis for them. This is clearly stated by the court in the very case cited by the appellant in his brief; namely, *United States and Social Security Board v. LaLane*, 152 F. 2d 43 (9th Cir., 1945):

“ . . . This same finality extends to the Board’s inference and conclusions from the evidence *if a substantial basis* is found for them . . .” (Emphasis added).

However, where the basis upon which the referee rests his inference and conclusions of law are faulty, arbitrary and capricious, as in the instant case, it is within the province of the District Court to reverse

the decision of the referee (Secretary). (See *Mac-Pherson v. Ewing, supra*). The Federal District Court is still the final authority in determining whether the referee has correctly applied the law to the facts, *Aubrey v. Folsom*, 151 F. Supp. 836 (1957), *Ayers v. Hobby*, 123 F. Supp. 115 (1954), and in reviewing the decision of the referee, said court must not abdicate its conventional judicial function. *Fuller v. Folsom*, 155 F. Supp. 348 (1957). As stated in *Miller v. Burger*, 161 F. 2d 992 (CA 9, 1947):

"... The argument is that this conclusion (of the Board) is not 'manifestly unreasonable' and must be sustained. This is on the theory that where an administrative agency is charged with applying general statutory language to a concrete factual situation, the courts will not disturb the conclusion reached.

"... Here we are not forced to consider a holding of the lower court which, in effect, substitutes the judgment of that court, on a set of facts for the judgment of the Board thereon. The lower court did not reach a decision contrary to the facts found by the Appeals Council. We believe that the ultimate question presented to the lower court was one of law."

A review of the decision of the referee in the instant case clearly shows that the only basis for the referee's conclusion that the appellee did not receive sufficient wages from his employer in 1953 and 1954 was that his corporate employer "did not show sufficient profit." Such is not a valid basis for the conclusion, much less a *substantial* basis. Furthermore, even in determining the amount of profit earned by the appellee's employer in the years involved, the referee and appellant made

certain arbitrary and capricious adjustments to the amounts shown on the employer's books and tax returns for said years, which said adjustments have no basis whatsoever under any accounting principles or the general rules of law applicable thereto.

CONCLUSION

The lower court in the instant case, after reviewing the entire record, found that the decision of the appellant in denying the claim of the appellee for social security benefits was due to an erroneous application of the law to the facts, and therefore must be considered, in law, to be arbitrary and capricious (R. 14). As stated by this court in *Folsom v. Pearsall*, 245 F. 2d 562 (CA 9, 1957), in affirming the lower court's reversal of the Secretary, the "conclusions of law drawn by the district court are entitled to great consideration, though not conclusive." The judgment of the lower court in favor of the appellee should be affirmed.

Respectfully submitted,

EUGENE E. FELTZ,
Of Attorneys for
Helmer F. Lindgren, Appellee.

JACOB, JONES & BROWN,
623 Public Service Building,
Portland, Oregon.

